

REPUBLIC OF MOLDOVA

TRANSITION TO PRIVATE POWER MARKET

**Regulatory Development
and Power Market Operations**

Moldova Energy Sector Reform
Contract No. LAG-I-00-98-00005-00
Task Order No. OUT-LAG-I-806-98-00005-00

Final Report

Prepared for:

U.S Agency for International Development
Office of Economic Restructuring
USAID/Ukraine

Prepared by:

Hagler Bailly
1530 Wilson Boulevard
Suite 400
Arlington, VA 22209-2406
(703) 351-0300

February 1999

REPUBLIC OF MOLDOVA

TRANSITION TO PRIVATE POWER MARKET

CONTENTS

1.	Introduction.....	1
2.	Role of the Regulator.....	1
3.	Investors' Perspective.....	1
4.	Promoting Investor Confidence in Moldova	2
5.	Desired Regulatory Attributes	2
6.	Tariffs	3
7.	Regulatory Accounting.....	4
8.	Development of Regulatory Expertise.....	4

1. Introduction

The transition to a privatized electricity market, from the regulatory perspective, primarily involves development of a regulatory system that potential investors believe will:

- Secure their investment;
- Support their efforts to improve both business operations and the physical asset infrastructure of the enterprise; and
- Provide a tariff level that produces profits consistent with investment risk.

Potential investors must be provided with a threshold level of commitments or guarantees at the outset and, for those matters left for ongoing adjudication, have confidence that the regulatory system will issue timely decisions that are fundamentally fair and reasonably predictable.

2. Role of the Regulator

The role of the National Agency for Energy Regulation (ANRE or "Regulator") should be that of an objective and neutral mediator of interests seeking to protect:

- a) The public interest in;
 - Adequate supplies of safe and reliable electric energy;
 - Promoting business and economic development for the improvement of the economy of Moldova;
 - Reasonable, affordable prices; and
- b) The private interests of investors in the privatized electricity system in:
 - Assurance that their investments are secure;
 - Freedom from interference in conducting their business in accordance with normal commercial practices; and
 - A reasonable opportunity to earn a fair return on their investments;

3. Investors' Perspective

Successful privatization requires investor confidence. Investors must have reason to believe that both their initial investment to purchase the company and new investments over time will be relatively safe. Investors will require assurances that the government (including the Regulator) will not make arbitrary decisions that reduce or eliminate the value of those investments. Investors must also have confidence that the tariffs that they are permitted to charge for electric service will provide them with a reasonable opportunity to earn (gain) a fair return on their investment consistent with their investment risks.

4. Promoting Investor Confidence in Moldova

To promote investor-confidence, as well as public confidence, procedures should be established that assure that the Regulator's decisions are objective and fair, and arrived at through an open process that the public and interested parties can see clearly, and in which they can participate fully.

For example, procedures should be established for the Regulator that require interested parties to present their supporting data (evidence) and arguments to the Regulator only through a public process where both sides of any disputed matter can have the opportunity to present their arguments and respond to the arguments of the other party. In this process the Regulator can take evidence or arguments from the parties both in written and oral form at public hearings. Copies of all written documents presented to the Regulator always should be provided to the opposing party as well. Such an open, transparent and public process, specifically prohibits any private meetings between the regulatory and any party so that no party has unfair opportunities to influence the Regulator and the decision-making process.

5. Desired Regulatory Attributes

In order to achieve the objective of engendering investor confidence the Regulator must:

- a) Have clear authority under applicable law to be the final arbiter, subject only to judicial appeal, of all matters affecting tariffs and terms and conditions of regulated services;
- b) Be permitted to exercise its independent judgement, free of political and governmental interference, but subject to an obligation to communicate with legislative and executive authorities;
- c) Be committed to pursue the public interest;
- d) Possess, or have access to, comprehensive technical competence in a broad range of disciplines, including:
 - Accounting;
 - Engineering;
 - Economics;
 - Finance;
 - Jurisprudence; and
 - Public relations.

The optimal situation, from the perspective of potential investors, would be one where:

- All of the above requirements have been achieved;
- The Regulator has shown good judgment and exercised common sense; and
- Such competent and fair regulation has been amply demonstrated over a considerable period of time.

Unfortunately, this ideal situation, if it can exist anywhere, is not one which Moldova can offer to investors presently, although the foundations for such performance in the future have been established.

ANRE, the energy regulator in Moldova, was created just over one year ago, under a Government Decree, and the foundational laws defining its independence and authority have been in effect for a very short time (since December 1998). The Regulator continues to be engaged in the legislative process for the purpose of protecting its hard-won authority in the Electric and Gas Laws from incursion by other laws prepared by uninformed and protectionist ministries reluctant to lose any of their historic authorities under the old command-and-control government structures.

The Regulator has not been fully staffed at either the Director or Staff levels for a variety of reasons. Although the Regulator has been able to issue initial licenses for the electric industry, it has been unable to do so for the gas industry due to unreasonable interference and demands by the Ministry of Justice. In the critical area of tariff setting, the Regulator has demonstrated its willingness to establish cost-based tariffs, but in doing so has incurred significant resistance from the Government. This resistance continues even though the Regulator recognizes the need to adjust tariffs in recognition of recent substantial exchange rate fluctuations.

6. Tariffs

Without a doubt, the most important, continuing problem to be overcome is the Government's resistance to ANRE's initiatives to increase retail tariff prices, even though price adjustments are necessary in order to achieve cost-compensatory tariffs. The Regulator has demonstrated its proactive support for the fundamental principle that tariffs must fully recover necessary costs on a timely basis. The Government, for the usual political and social reasons, is a recurring obstacle to any proposed price increases, although it did support finally price increases sought by ANRE to reflect deflation of the leu resulting from the economic crisis throughout the NIS in 1998.

In addition, overly broad, Government-mandated subsidy programs must be funded, nominally, under various laws and decrees by the industry rather than the National Budget. Industry debts to foreign suppliers remain a potential privatization and tariff issue for investors, even if the Government transfers such debt from the companies to budget accounts. Without expeditious resolution of these problems, potential investors are presented with a high level of uncertainty, which translates to investment risk and higher costs, assuming an investor is ready to accept these risks.

The integrity of the tariff setting process is critical to potential investors. As noted above, elimination of Government interference and resolution of the issues of default industry funding of subsidy programs and "old debt" are important, necessary steps to address tariff issues important to investors. Once these are resolved, the next step is development by the Regulator of a level of expertise in the tariff setting process that investors perceive to be both comprehensive and enlightened.

ANRE has demonstrated the ability to develop rudimentary tariffs and has aggressively sought to maintain overall price levels reflective of actual costs. The currently effective tariffs are rudimentary because so far the Regulator only has access to very basic and crude cost, sales and revenue information, which nonetheless represents the best information that is available from the enterprises for tariff setting. For purposes of determining "eligible" operating costs, capital recovery and return on capital ANRE has relied on either very simplistic measures or old 'Soviet Norms'. Current tariff setting methodologies reflect a transition approach routed in historic practices and applied to practical realities of State-owned and operated entities, but reaching toward free market economic principles. A private investor is not likely to find these current methods sufficiently reliable or acceptable and can be expected to seek to obtain conditions attached to any asset purchase which will mitigate such tariff risks .

7. Regulatory Accounting

A necessary precondition for proper tariff development is elaboration of accounting requirements and standards that produce accurate and reliable data and information in a systematic and consistent manner. Hagler Bailly has separately prepared recommendations for a Regulatory Accounting System compliant with both the IAS and Moldova's National Accounting Standards for adoption by the Regulator.

Completion of this step is important but will not provide a useful product until the regulated enterprises develop the internal expertise and discipline to properly record and report data in a manner consistent with the Regulatory standards. However, this deficiency will not be viewed as an impediment to a potential investor because the rudimentary book keeping and accounting systems at the enterprises are well known and accepted as one of the liabilities of a strategic investment in the NIS. A strategic investor will be prepared to fund the necessary computer systems and to provide the extensive personnel training and experienced supervision required for implementation. In fact, Moldova's privatization strategy assumes this enterprise infrastructure development, and its cost, occurs post privatization.

8. Development of Regulatory Expertise

In the ideal case, what the private investor, after funding and implementing an expensive cost accounting system, wants to know is that the Regulator will understand how to use the data output in a reasonable and consistent manner to authorize cost compensatory tariffs and exercise

proper regulatory oversight. For tariff setting, this means the Regulator is capable of applying sophisticated cost analysis, complex depreciation principles and intricate cost of capital calculations.

For ANRE, a regulator which has existed for only one year in an environment that is bereft of any relevant historical precedents, this is not a very realistic expectation from the investor viewpoint. And, investor expectations are the primary driving force in all capital markets.

ANRE is expected to develop the full set of skills and expertise associated with mature energy regulatory agencies over time, but it cannot demonstrate mastery of these regulatory complexities within the time frame of expected privatization during 1999.

In these circumstances, it is reasonable to expect that, as part of the privatization process, investors will want to have assurance that the cash flows required to support their bid price for an entity, and perhaps future capital additions, is determined in advance for a specified term of years. Such an approach imposes more risks on Moldova, but may be a necessary cost to obtain the strategic private investment critical to revitalize the power sector and to secure Moldova's economic future.

As ANRE begins to confront and implement a complex and sophisticated regulatory regime which includes responding appropriately to the demands associated with a successful power sector privatization, it will need to learn much about Western economics and finance in a very short period if it is to properly exercise its role as energy regulator. In the short-run, this will require continuing technical assistance from Western advisors with the required expertise and experience in the NIS.

The Regulator needs experienced and knowledgeable guidance when it initially confronts issues that deal with determining, in specific circumstances, what are "reasonable and necessary" costs, what are proper depreciation practices and, most difficult of all, what are compensatory returns on and of invested capital. If the investor knows that the Regulator has access to impartial and knowledgeable technical advice during the initial implementation phase of regulation, many concerns about being dependent upon a novice Regulator will be ameliorated.

Understanding the fundamental economic concepts underlying utility regulation are essential, but may not lend themselves to direct application in Moldova in the near-term. Rather, what is required is assistance to understand and analyze alternative pricing proposals from potential investors which are intended to reach similar economic results, but are structured in ways which meet the needs of new private investors in Moldova.